



Audit
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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

REGION V
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Investigation
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SEP 30 2003

Control Number ED-OIG/A05-D0024

Mr. Robert L. Duffy, Superintendent
Career Success High School
1777 W. Camelback Road, N-100
Phoenix, AZ 85015

Dear Mr. Duffy:

This **Final Audit Report** presents the results of our audit of Career Success High School's (School) use of U.S. Department of Education (ED) funds for the period July 1, 2001, through June 30, 2002 (project period). The objective of our audit was to determine if the School expended ED funds according to the law and applicable regulations.

Our audit disclosed that the School did not expend Public Charter Schools Program (PCSP) grant funds in accordance with the law. Of the \$200,000 in PCSP funds received for the project period, the School used \$16,884¹ for unallowable costs.

We provided the School with a draft of this report. The School did not concur with the finding and recommendation to refund PCSP funds to ED presented in this final report. The School concurred that it did not have policies and procedures in place to provide reasonable assurance that PCSP funds were expended for allowable activities during our audit period. It provided a detailed justification explaining why it considered costs allowable. Our review of the School's explanation caused us to change our finding in this report by eliminating some costs (i.e., basketball jerseys and membership fees) that we initially identified as being unallowable. We also modified our procedural recommendation to reflect that the School informed us that it had implemented policies and procedures. The School's comments are summarized in the body of the report and included in their entirety as an attachment.

¹ The School charged \$201,002 to the PCSP grant, \$1,002 more than the \$200,000 in PCSP funds it received for the project period. Therefore, we will only recommend recovery of \$15,882 (\$16,884 in unallowable costs less \$1,002).

AUDIT RESULTS

Finding No. 1 The School Charged \$16,884 in Unallowable Costs to the PCSP Grant

The School charged \$16,884 to the PCSP grant for costs that were unallowable. We judgmentally² selected 41 expenditures totaling \$80,074 from the 145 expenditures totaling \$201,002 charged to the PCSP grant for the project period. We reviewed supporting documentation such as requisition forms, purchase orders, invoices, and canceled checks for these 41 expenditures and noted that 10 were for accounting and legal services.³ These accounting and legal services expenses were not part of the School's initial startup costs and, therefore, were not reasonable and necessary for the initial implementation of the School. The School should have paid these expenses from other sources.

The Elementary and Secondary Education Act of 1965, as amended by the Improving America's Schools Act of 1994, Title X, Part C, Section 10304(f)(3), and the Charter School Expansion Act of 1998,⁴ allows charter schools to spend funds for activities related to post award planning and design of the educational programs and initial implementation of the charter school. Activities related to initial implementation may include (a) informing the community about the school, (b) acquiring necessary equipment and educational materials and supplies, and (c) acquiring or developing curriculum materials. Charter schools are allowed to pay for other initial operational costs not met by other sources provided that those costs are directly related to the intended purpose of the grant. The intent of the PCSP grant is to pay for necessary items and services that would support the initial implementation and operations of the school while also allowing the school to become financially independent. Additionally, pursuant to Office of Management and Budget Circular No. A-122, *Cost Principles for Non-Profit Organizations*, Attachment A, Section A, paragraphs 2(a) and 3(a), to be allowable, a cost must be reasonable, allocable, ordinary, and necessary for the operation of the organization or the performance of the award.

The School did not have policies and procedures in place to provide reasonable assurance that PCSP funds were expended for activities allowable under the law. Instead, School officials relied on their own interpretation of the charter school law when expending PCSP funds. The costs we identified as unallowable were not included in the School's PCSP grant budget. Had School officials reviewed their PCSP grant budget or contacted an ED charter school program official before incurring these costs, the School may not have expended PCSP funds on unallowable costs.

² We selected large dollar expenditures and/or those with cost descriptions that, in our opinion, were inconsistent with the intent of the PCSP grant.

³ The accounting and legal services expenses were used to pay for dissolution of the School's partnership.

⁴ The law was further amended by the No Child Left Behind Act of 2001, Title V, Part B.

Because School officials used \$16,884⁵ in PCSP grant funds to pay for general operational costs, the School was unable to use those funds to purchase items that would increase the chances of the School becoming financially independent.

Recommendations

We recommend that the Chief Financial Officer, Office of the Chief Financial Officer, in conjunction with the Deputy Under Secretary for Innovation and Improvement, instruct the School to

- 1.1 refund \$15,882⁶ to ED; and
- 1.2 provide evidence that it has implemented policies and procedures that provide reasonable assurance that ED funds are expended on activities that are allowable under the law.

Auditee Comments

The School disagreed that it charged unallowable costs to the PCSP grant. The School's Superintendent of Schools (Superintendent) stated that the School considered the legal and accounting fees to be startup costs. The Superintendent explained that the legal and accounting fees were allowable during the first year of the grant, and the School did not receive direction that these costs would not be allowable during the second year.

The School agreed that, during the audit period, it did not have controls in place to ensure that PCSP funds were expended on allowable activities. The Superintendent stated that the School went through some major internal management and personnel changes that had a direct affect on the School's ability to track and report on changes in its grants management system. The Superintendent informed us that the School has reconstructed the accounting records for the 2001 – 2002 school year and used the same accounting procedures for the 2002 - 2003 school year. Additionally, the School developed policies and procedures that were implemented during the 2002 – 2003 school year. These policies and procedures were implemented to ensure that PCSP funds were expended according to law and applicable regulations.

⁵ Comprised of accounting and legal services expenses totaling \$16,884.

⁶ The School charged \$201,002 to the PCSP grant, \$1,002 more than the \$200,000 in PCSP funds it received for the project period. Therefore, we only recommend recovery of \$15,882 (\$16,884 in unallowable costs less \$1,002).

OIG Response

We reviewed the School's comments and found no basis for changing our position that the accounting and legal services expenses charged to the PCSP grant were unallowable. The School admitted that these expenses were incurred as a result of the dissolution of the School's original partnership. The PCSP funds expended for the dissolution of the School's partnership were not necessary for the initial implementation and operation of the School.

BACKGROUND

The purpose of the PCSP is to provide grants for the planning, design, and initial implementation of charter schools created by members of the local community. Grants may be made for a period of up to three years. Funds may be used to plan and design the education program of the charter school and evaluate the effects of charter schools.

Charter schools are governed by the charter school legislation enacted in the Elementary and Secondary Education Act of 1965, as amended by the Improving America's Schools Act of 1994, Title X, Part C, Section 10304(f)(3), and the Charter School Expansion Act of 1998.⁷ Charter schools that receive a grant directly from the federal government must also adhere to regulations listed in 34 C.F.R. Parts 75, 82, and 99.

The School received its charter from the Arizona State Board of Education and opened in August 2000. The School applied for a PCSP grant and received its award from ED on May 11, 2000. The grant provided the School with startup funding for a three-year period. For the project period (July 1, 2001, through June 30, 2002), the School received \$200,000 in PCSP grant funds.⁸

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to determine if the School expended ED funds according to the law and applicable regulations. Our audit covered \$50,000 authorized by ED on June 16, 2001, \$150,000 authorized by ED on July 24, 2001, and costs charged to the PCSP grant for the project period.

To accomplish our objective, we

- interviewed School personnel;
- reviewed accounting records showing 145 expenditures totaling \$201,002 charged to the PCSP grant for the project period;
- judgmentally selected 41 expenditures totaling \$80,074. We selected large dollar expenditures and/or those with cost descriptions that, in our opinion, were inconsistent with the intent of the PCSP law; and

⁷ The law was amended by the No Child Left Behind Act of 2001, Title V, Part B.

⁸ The School received authorization for \$50,000 in June 2001 and an additional \$150,000 in July 2001.

- compared the accounting records with supporting documentation (requisition forms, purchase orders, invoices, and canceled checks) to determine if the 41 expenditures were allowable and supportable.

We also relied, in part, on computer-processed data that the School maintained using Peachtree® and QuickBooks®. We compared the School's data with information from ED's Central Automated Processing System. We also compared the School's supporting documentation (such as requisition forms, invoices, purchase orders, and canceled checks) with the School's computerized accounting records. Based on our tests, we concluded the data were sufficiently reliable to be used in meeting the audit's objectives. We performed our audit work between December 2002 and March 2003. We visited the School on December 3, 2002, and discussed the results of our audit with School officials on March 25, 2003.

Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of audit described above.

STATEMENT ON MANAGEMENT CONTROLS

As part of our audit, we did not assess the adequacy of the School's management control structure applicable to all ED awards because this step was not necessary to achieve our audit objective. Instead, we relied on testing of the School's compliance with the PCSP law and applicable regulations. Our testing disclosed a material weakness in the School's management controls over ED awards. The School did not have policies and procedures in place to provide reasonable assurance that PCSP funds were expended according to the law. This weakness is discussed in the **AUDIT RESULTS** section of this report.

ADMINISTRATIVE MATTERS

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken will be made by the appropriate ED officials.

If you have additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following ED officials, who will consider them before taking final action on the audit.

Jack Martin
Chief Financial Officer
Office of the Chief Financial Officer
400 Maryland Avenue, SW, Room 4E313
Washington, DC 20202

Nina Shokraii Rees, Deputy Under Secretary
Office of Innovation and Improvement
U.S. Department of Education
400 Maryland Avenue, SW, Room 4W317
Washington, DC 20202

It is ED's policy to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be greatly appreciated.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard J. Dowd", is written over a horizontal line.

Richard J. Dowd
Regional Inspector General
for Audit

Attachment

Career Success Schools

A Student Ownership Approach to Learning and Success

1777 W. Camelback Rd. N-100
Phoenix, AZ 85015

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Mr. Richard Dowd
Regional Inspector General for Audit
U.S. Department of Education
Office of Inspector General
111 N. Canal St., Suite 940
Chicago, IL 60606

August 29, 2003

Dear Mr. Dowd,

Response to Draft Audit Report – Career Success High School
Audit year - 2001-02

Finding 1.1 The School Charged Unallowable Costs to the PCSP Grant

Response: We accept the fact that 13 items were determined unallowable – primarily legal services, basketball jerseys and membership fees – totaling \$18,131.

Rationale: The costs were charged to our PCSP grant with the understanding that they would be considered startup costs. A clear definition of what constitutes a "start-up cost" was never made clear by the department in the 3 years of participation. I personally attend 2 workshops in Phoenix and a seminar at the national convention in Washington DC where Donna Hoblit spoke on what constituted a "start-up cost." Other than the general categories of wages, construction and obvious expenses not related to start-up, many costs were left to interpretation.

The basketball jerseys were required as part of a start-up program we deemed important by offering athletics to our students. We were fortunate to join a league that had a full schedule that ran for 3 months. Fifteen boys were outfitted for jerseys and participated. The basketball program had a positive affect on our inner city youth and their attendance and personal feeling of self worth. Many students had not played on an organized athletic team and now, because of the program, have the opportunity.

The membership fee was to join the Arizona Charter School Association - \$450. We considered this a "start-up" cost in that we could join an association that would assist us in our initial growth and insure success as a charter school. Belonging to the Association and being an "active" member meant that we would be informed on issues, reporting procedures and dates, receive necessary assistance when needed and share ideas and grow along with other successful charters. Active membership would only enhance our stability as a charter school.

The use of PCSP money for these two items in its 2nd year of operation was solely intended to further establish a more solid school.

The legal and accounting fees were charged to the PCSP money using a similar interpretation – necessary costs to insure the success of the charter. The 1st year of the PCSP grant allowed this expenditure. We did not receive any direction that these costs would not be allowed the 2nd year.

Finding 1.2 Lack of Policies and Procedures in Place to Provide Reasonable Assurance that PCSP Funds were Expended for Activities Allowable Under the Law

Response: During the second year of the grant 2001-01 Career Success High School went through some major internal management and personnel changes that had a direct affect on our grants management in terms of tracking and reporting.

Rationale: The 2001-02 school year (2nd year of PCSP Grant for Career Success High School) began with two other partners – a Jeff DeMatte and Elisha Madden. Though I am the charter holder, both gentlemen partnered with me in starting Career Success the year before. Jeff handled all financial functions including federal "start-up" and title monies. He kept the checkbook, approved and made all purchases while Elisha and I ran the day-to-day operations.

To complicate matters more Jeff and Elisha were starting their own schools as charter holders. The three of us continued to work together and share responsibilities in the total operations of the 3 schools.

Unfortunately controls were not put in place. Helen Fortune was named principal of Career Success HS that 2nd year. She offered very little in terms of expertise with grant dollars. Jeff did the best he could, but again with little direction. All records and transactions were kept in Peachtree.

Consequently, I accept the blame in that I assumed that everything was in compliance since we had the services of a reputable CPA firm – Zolondek, Strassels, Greene - Phoenix, AZ

In February 2002 the partnership was dissolved and I immediately turned all financial functions - payroll, accounts payable/receivable, tax filings, budgeting, reporting, reconciliation's - over to ETC (Educational Technologies Consultants – Chandler, AZ), a reputable accounting firm of 3 years servicing only charter schools.

Both accounting fees and legal fees were incurred when our partnership dissolved. Zolondek had to provide a year-to-date summary of all financials for the transition and our attorney drew up and supplied the necessary documents for dissolution.

To further complicate matters in April, 2002, I hired a business manager who had worked in the same capacity at a charter school. She was competent in some areas but lacked the understanding of grants management. She was terminated in September, 2002. Since that time Judy Coleman, a full-time consultant, has taken over our grants management and was able to straighten out all of the records and set procedures for spending in 2002-03.

We are very pleased with the work of both ETC and Judy Coleman. We are still with ETC for all of are financial needs. In February of 2002 they reconstructed the entire 2001-02 school year in Quick Books for the purposes of our 2001-02 independent audit. This past month they have also taken over our grants management which assures our implementation and adherence to policies and procedures for all federal spending.

Going forward, we now have the policies and procedures in place and our 2002-03 use of PCSP funds have been expended properly.

In closing I would like to emphasize that the funds over the past 3 years have been put to good use and has strengthened the school to become financially independent. The 2001-02 audit shows an increased cash flow of over \$150,000 for the year.

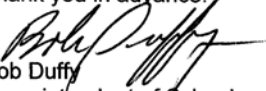
Also please understand that there was never an attempt to openly use the funds inadvertently. A lack of understanding of what constituted PCSP dollars and numerous key personnel changes over the past 18 months led to your findings and conclusions.



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Career Success High School stands ready to refund the amount indicated to the Department of Education if that is the case. I would hope, however, that the department would forgive the error in judgment on interpretation and allow the school to keep the funds.

Thank you in advance.


Bob Duffy
Superintendent of Schools
Career Success Schools
Direct Line – 602-380-7993